Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses even as the final August manufacturing PMIs again highlighted ongoing weakness in the sector and an ifo survey suggested that German auto manufacturers are increasingly downbeat.
- Despite soft manufacturing PMIs and a further big drop in house prices, Gilts also made losses as the level of UK GDP was revised up significantly.
- The coming week brings new data for euro area retail sales and producer prices, German factory output and orders, as well as UK surveys of jobs and business inflation expectations.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	2.968	+0.012
OBL 2.4 10/28	2.518	+0.052
DBR 2.6 08/33	2.539	+0.080
UKT 0⅝ 06/25	5.136	+0.015
UKT 1⅝ 10/28	4.688	+0.038
UKT 3¼ 01/33	4.409	+0.055

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

Manufacturing PMIs illustrate significant challenges, with weakness most striking in Germany

There were no major surprises from the final August manufacturing PMIs, which echoed the findings from the flash release that the sector continues to face significant challenges amid weakening global demand and the ongoing energy shock. Indeed, despite a modest uptick from July's 38-month low, the euro area's output index (43.5) was revised down from the flash estimate and marked the fourteenth consecutive sub-50 'contractionary' reading, to leave it trending so far in Q3 more than 3pts below the Q2 average. The manufacturing performance among the member states was mixed. But with the exception of Greece and Ireland, the surveys were consistent with ongoing contraction. And perhaps inevitably, in line with the Commission's survey, the PMIs suggested that Germany's manufacturing sector continues to struggle most, with the respective output PMI (39.4) the lowest since the global financial crisis when excluding the initial plunge at the start of the pandemic, to be trending more than 7pts below the Q2 average. While the French (45.9) and Italian (43.8) indices rose around 2pts in August, they too implied a further decline in output, while the Spanish PMI (46.1) fell to an eight-month low.

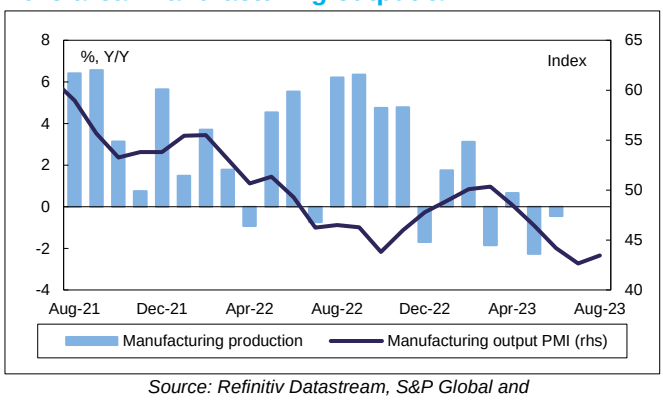
Falling demand continues to dampen price pressures in the factory sector

While manufacturers were fractionally less pessimistic about their expectations for the coming twelve months, today's survey suggests that the near-term production outlook remains weak. Certainly, the euro area's new orders component (39.0) fell to its second-lowest level on the 26-year series when excluding the first Covid-19 wave and the global financial crisis, with demand from home and abroad waning. Backlogs of work continued to fall sharply, while firms reduced substantially further their component inventories. Manufacturers also cut headcount for a third consecutive month, albeit only slightly. At the same time, wage pressures seem to be of limited concern in the sector. Indeed, while the euro area input costs PMI jumped in August, perhaps reflecting the pickup in wholesale energy prices, at 40 it still implied significant deflationary pressures in the sector. The output price PMI (46.0) was similarly one of the weakest readings since 2009 and consistent with an ongoing downtrend in consumer goods price inflation over coming months.

German auto manufacturers significantly more downbeat about near-term outlook

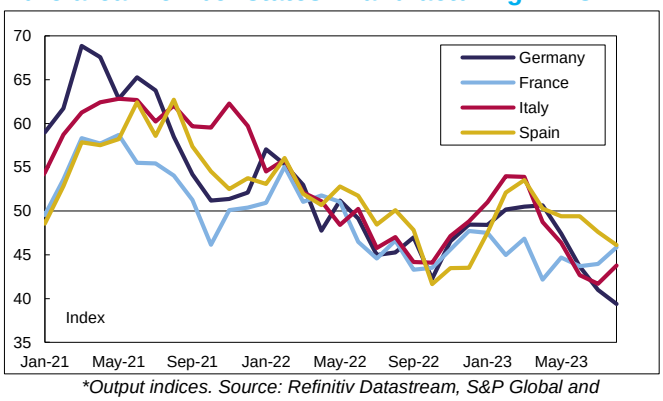
In part, given its high degree of interest rate sensitivity, the deterioration in conditions in the euro area's manufacturing sector reflects the ECB's substantive monetary tightening on demand for goods and investment plans. But structural challenges are compounding the current cyclical weakness. With wholesale gas and electricity prices still more than double their pre-pandemic levels, and natural gas futures for winter delivery having recently increased sharply, the euro area's energy-intensive sub-sectors, such as chemicals and metals, still face an existential competitiveness challenge. Likewise, given its

Euro area: Manufacturing output & PMI



Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area member states: Manufacturing PMIs*



**Output indices. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

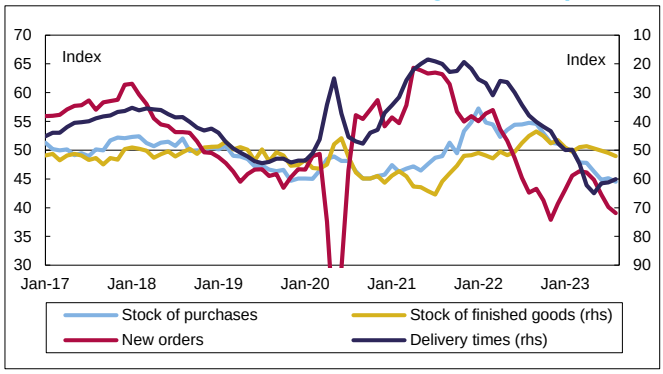
slow response to shifts in demand towards electric vehicles, Germany's all-important auto sector faces an increasingly uncertain outlook. According to the latest ifo institute survey, German auto suppliers judged conditions to have remained broadly favourable in August. But auto manufacturers reported a marked deterioration in current conditions with the respective index down 35pts to a six-month low of -0.3. And with the survey's measure of order backlogs falling to its lowest for more than three years, inventories the highest in more than three years, and demand having weakened significantly, auto manufacturers were significantly more downbeat about the outlook for business over the coming six months, with the respective index (-76.6) the lowest since November 1992.

The week ahead in the euro area

The coming week will bring further updates on euro area inflation, with the release on Tuesday of July's producer price figures, the latest ECB consumer expectations survey and the final August services PMIs. Like in Germany, euro area producer prices are likely to illustrate the steady downtrend in factory sector costs, with the annual PPI rate expected to fall further into negative territory to about -7½%Y/Y, its weakest level for more than three years. Meanwhile, the ECB survey measure of inflation expectations one year ahead might have fallen further in July, from 3.4%Y/Y previously, although the Commission survey this week suggested an increase might be in store. But likely of greater significance for Governing Council members will be developments in medium-term household expectations, for which the median forecast for three years ahead remained above the ECB's 2% target in June (2.3%), albeit easing to its lowest rate since February 2022. The services price PMIs will also be watched. The preliminary release reported an unexpected uptick in the input price component (up 1.5pts to 62.5) amid continued firm wage growth in the sector. The flash euro area services activity PMI (48.3) also saw a marked deterioration in August, implying contraction in the sector for the first time in eight months and the steepest drop since February 2021. The construction PMIs (Wednesday) and Sentix investor survey (Monday) will also offer an update on economic conditions over the summer period.

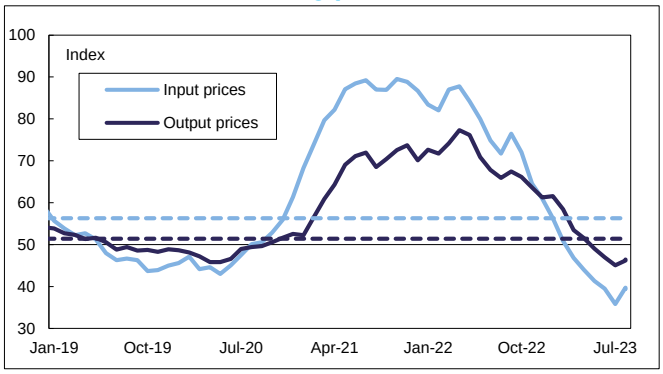
In terms of hard economic data, euro area retail sales numbers (Wednesday) will offer an update on spending in July. Given declines in Germany (-0.8%M/M) and France (-0.3%M/M), euro area retail sales are also expected to have started the third quarter on the back foot. Updated euro area national accounts data for Q2 (Thursday) are likely to confirm that the economy grew 0.3%Q/Q, although today's 0.1ppt downwards revision in Italy (to -0.4%Q/Q) raises the probability of a downwards revision for the euro area as a whole. The first official expenditure breakdown of euro rea GDP is expected to show that growth was supported by net trade and private inventories, while consumption remained lacklustre. Among the member states' releases, German goods trade (Monday), factory orders (Wednesday) and industrial production (Thursday) figures will provide an update on manufacturing sector conditions at the start of Q3. French and Spanish industrial production numbers for July are also due (Friday).

Euro area: Selected manufacturing PMI components



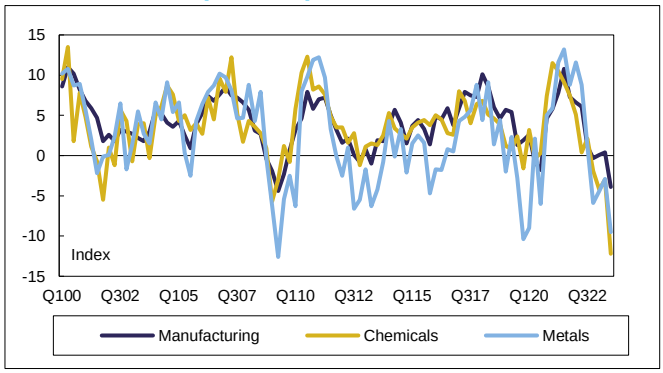
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing price PMIs*



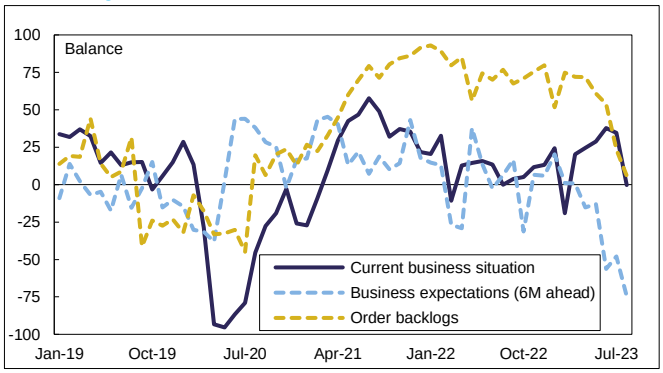
**Dashed lines represent long-run average. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area: Competitive position in domestic market



Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: ifo auto manufacturer sentiment indices



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK

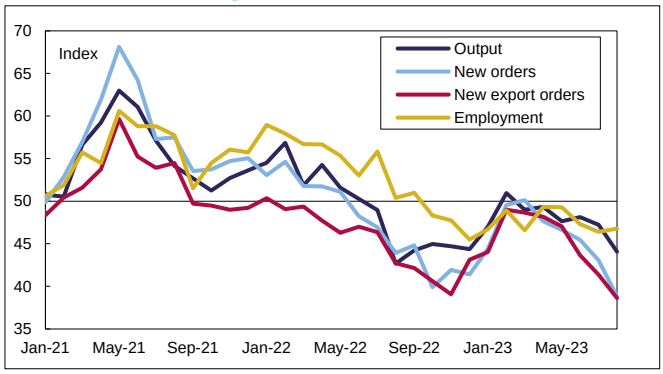
August manufacturing PMIs not as bad as flash estimates but still signal sharp contraction in Q3

In contrast to the euro area, the UK's final manufacturing PMIs for August were not quite as downbeat as the preliminary estimates. However, they still suggested a marked deterioration in the sector from July, and signalled the strong likelihood that manufacturing production will contract significantly in Q3 after growing a surprisingly vigorous 1.6%Q/Q in Q2. In particular, the output PMI was revised up 0.8pt from the flash estimate to 44.1. Nevertheless, that was still the lowest in twelve months. Despite a modest upwards revision, at 38.8 the new orders index was the lowest since the first wave of Covid-19 in May 2020 and, bar that the weakest since the global financial crisis. The index for new export orders was similarly weak, with S&P Global reporting anecdotes of weaker demand from all major markets. At the sectoral level, the weakness was broad-based. Producers of capital and consumer goods reported declines in output and new orders. But with purchases of inputs down at the sharpest rate in 3½ years, manufacturers of intermediate items appear to be suffering most of all. Meanwhile, with supply-chain obstacles removed, firms' backlogs of work also fell to the lowest since 2009 excluding the initial lockdown period. So, the near-term production outlook appears gloomy. As a result, manufacturers reported further reductions in staff headcount. With demand weaker, the input cost PMI (43.0) was sub-50 for the fourth successive month and the lowest in more than seven years, with prices falling for a range of energy, commodity and intermediate items. But perhaps frustratingly for the BoE, the reported decline in output prices was minimal, with the respective PMI revised up from the flash estimate to 49.5.

House prices fall in August at steepest annual rate in 14 years

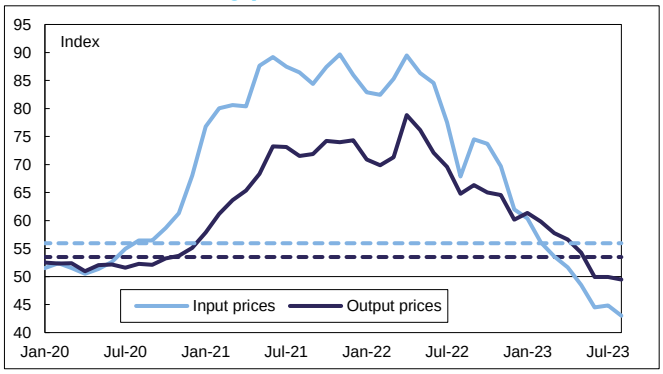
According to Nationwide seasonally-adjusted data, house prices fell in August by a further 0.8%M/M, the sharpest drop since March. That accelerated the annual rate of decline a further 1.5ppts to -5.3%Y/Y, the steepest since July 2009. The falls in house prices are an inevitable consequence of stretched affordability for first-time buyers caused by higher mortgage rates. For example, the average rate on a 2Y fixed-rate 75% loan-to-value mortgage in July reached 6.26%, almost 280bps above a year earlier and about 500bps higher than two years earlier. And average monthly mortgage approvals have been running more than 25% below the average in the two years before the pandemic. While cash buyers have provided support, total transactions have been down more than 12% on the same basis. Nevertheless, despite the pressures placed on mortgage holders refinancing at higher rates, arrears have remained low. Typical mortgage holders have significant equity in their properties. Lenders have agreed support for homeowners struggling with increased repayments. While it is now rising, unemployment remains historically low. And real wage growth has turned positive. So, levels of forced home-selling should remain modest, ensuring that UK house price deflation remains gradual and orderly. Nevertheless, while rates on new

UK: Manufacturing PMIs



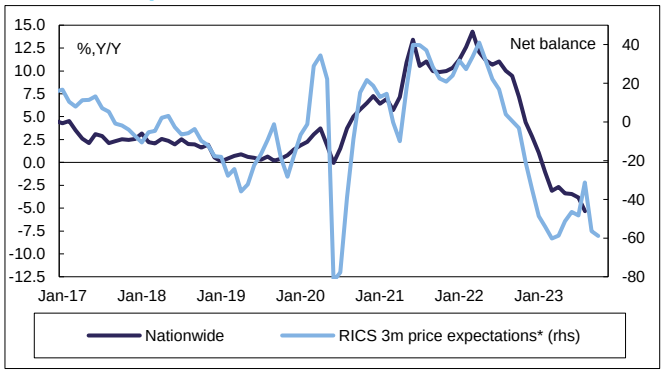
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing price PMIs*



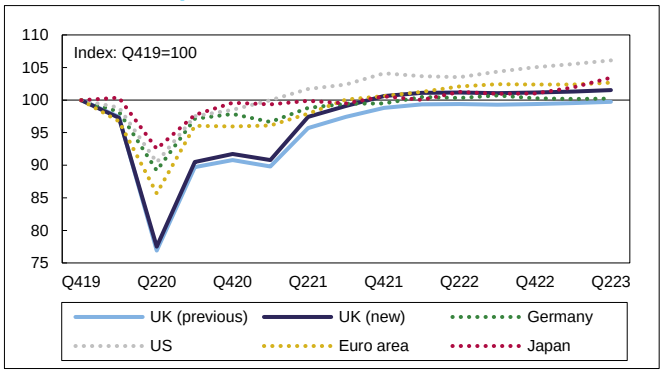
**Dashed lines represent long-run averages. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

UK: House price indicators



**Three-month lead. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: GDP comparisons*



**UK (new) includes revision to Q421 and current growth estimates thereafter. Source: ONS, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

mortgages have been cut over recent weeks, and the reduction in household energy prices in October should also provide further relief for borrowers' cash flow, home prices look set to fall further over the coming months. In its latest survey, the RICS survey indices for expected home prices over the coming three months and twelve months both fell to their most negative levels so far this year. And the ultimate drop in prices from the peak in August 2022 could yet reach double-digit percentage territory if the UK economy succumbs to recession in 2024. Moreover, with new sales instructions and new buyer enquiries also still firmly in negative territory, housing market transactions look set to remain low too.

Economic performance over the pandemic not quite as woeful as previously thought

For some time, the UK's economic performance since the start of the pandemic has appeared woeful and the worst of all G7 countries. However, the ONS today published major revisions to its estimates of GDP over that period, which suggest that the performance was better than previously thought. Strikingly, real GDP growth in each quarter from Q220 to Q221 was revised up. As a result, the level of GDP in Q421 is now estimated to be 0.6% above the pre-pandemic level in Q419, having previously been estimated to be 1.2% below that benchmark. At the sectoral level, the upwards revision was driven by services, with margins higher in wholesale and retail trade and output higher in healthcare. Only modest adjustments were made to other services. And manufacturing output and other industrial production categories are now estimated to have been weaker than previously thought.

Higher GDP level might suggest need for more pronounced slowdown over coming quarters

The official series for GDP, including the most recent quarters, will be brought up to date in October. But assuming no significant negative revisions are made to the data for 2022 and 2023, those figures will show that economic output in Q223 was about 1½% above the pre-pandemic level rather than the current estimate of 0.2% below that benchmark. So, unless and until similar new methodologies are applied to other countries, the UK economy will no longer lag all of the rest of the G7, with Germany instead having had the weakest performance since the pandemic. The higher level of UK GDP might help to explain some of the strength of the recent jobs market, including the low level of unemployment and rapid wage growth, over the past two years. And while it suggests that labour productivity has been stronger than previously thought, it could also suggest that the UK economy is running further above its potential level than the BoE has estimated to-date, implying the need for a more pronounced slowdown (i.e. a recession) over coming quarters to squeeze inflation out of the system.

The week ahead in the UK

The coming week should be relatively quiet on the UK economic data front. Tuesday will bring the BRC retail sales survey, final services PMIs and SMMT new car registrations data, all for August. The BRC survey is likely to echo the findings of the CBI distributive trades survey to point to another month of subdued sales following the sizeable weather-affected drop in July. And the final services PMIs are likely to repeat the weak message of the flash release, whereby the headline activity index fell almost 3pts to a seven-month low of 48.7 to point towards contraction, while the new orders index also fell below 50 to a nine-month low. Nevertheless, the preliminary release also pointed to still-substantive cost pressures in the sector, with the input (68.4) and output price (56.2) indices both still very high by historical standards despite easing back slightly from July. The other notable day for UK economic data in the coming week will be Thursday, when the latest REC report on jobs and BoE Decision Maker Panel (DMP) survey results are due. The REC survey is likely to point to a continued loss of momentum in the labour market, with moderating labour demand, increased staff availability and somewhat less pressure on starting salaries. The principle focus of the DMP survey will be business inflation expectations after the July survey reported that one-year ahead CPI inflation expectations fell 0.3ppt to 5.4%Y/Y while three-year ahead expectations dropped 0.4ppt to 3.3%Y/Y. Beyond the economic data, BoE Governor Bailey and colleagues will testify before the House of Commons Treasury Select Committee on Wednesday.

The next edition of the Euro wrap-up will be published on 05 September 2023

The coming week's data calendar

The coming week's key data releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
Monday 04 September 2023					
Euro area	09.30	Sentix investor confidence	Sep	-19.7	-18.9
Germany	07.00	Trade balance €bn	Jul	18.0	18.7
Spain	08.00	Unemployment change '000s	Aug	-	-11.0
Tuesday 05 September 2023					
Euro area	09.00	ECB 1 (3) year ahead CPI expectations Y/Y%	Jul	-	3.4 (2.3)
	09.00	Final services (composite) PMI	Aug	*48.3 (47.0)*	50.9 (48.6)
	10.00	PPI Y/Y%	Jul	-7.6	-3.4
Germany	08.55	Final services (composite) PMI	Aug	47.3 (44.7)	52.3 (48.5)
France	08.50	Final services (composite) PMI	Aug	*46.7 (46.6)*	47.1 (46.6)
Italy	08.45	Services (composite) PMI	Aug	50.5 (48.1)	51.5 (48.9)
Spain	08.15	Services (composite) PMI	Aug	51.5 (51.0)	52.8 (51.7)
UK	00.01	BRC retail monitor, like-for-like sales Y/Y%	Aug	-	1.8
	09.00	New car registrations Y/Y%	Aug	-	28.3
	09.30	Final services (composite) PMI	Aug	*48.7 (47.9)*	51.5 (50.8)
Wednesday 06 September 2023					
Euro area	08.30	Construction PMI	Aug	-	43.5
	10.00	Retail sales M/M% (Y/Y%)	Jul	-0.1 (-1.2)	-0.3 (-1.4)
Germany	07.00	Factory orders M/M% (Y/Y%)	Jul	-4.0 (-3.9)	7.0 (3.0)
	08.30	Construction PMI	Aug	-	41.0
France	08.30	Construction PMI	Aug	-	42.9
Italy	08.30	Construction PMI	Aug	-	48.0
UK	09.30	Construction PMI	Aug	50.5	51.7
Thursday 07 September 2023					
Euro area	10.00	Final GDP Q/Q% (Y/Y%)	Q2	*0.3 (0.6)*	0.0 (1.1)
	10.00	Final employment Q/Q% (Y/Y%)	Q2	*0.2 (1.5)*	0.5 (1.6)
Germany	07.00	Industrial production M/M% (Y/Y%)	Jul	-0.5 (-2.1)	-1.5 (-1.7)
France	07.45	Trade balance €bn	Jul	-	-6.7
Italy	09.00	Retail sales M/M% (Y/Y%)	Jul	-	-0.2 (3.6)
UK	09.30	BoE DMP 1 year ahead CPI expectations Y/Y%	Aug	5.0	5.4
Friday 08 September 2023					
Germany	07.00	Final HICP (CPI) Y/Y%	Aug	*6.4 (6.2)*	6.5 (6.4)
France	07.45	Industrial production M/M% (Y/Y%)	Jul	0.0 (1.3)	-0.9 (-0.3)
Spain	08.00	Industrial production M/M% (Y/Y%)	Jul	-	-1.0 (-3.0)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions		
Country	BST	Event / Auction
Monday 04 September 2023		
Euro area	14.30	ECB President Lagarde scheduled to speak
Tuesday 05 September 2023		
Euro area	09.00	ECB to publish Consumer Expectations Survey results
Germany	10.30	Auction: €400mn of 0.1% 2033 index linked bonds
	10.30	Auction: €200mn of 0.1% 2046 index linked bonds
Wednesday 06 September 2023		
Germany	10.30	Auction: €5bn of 2.6% 2033 bonds
UK	10.30	Auction: £4.0bn of 4.5% 2028 bonds
	14.15	BoE Governor Bailey to testify to Treasury Select Committee on the MPC's latest Monetary Policy Report
Thursday 07 September 2023		
France	09.50	Auction: To sell 3% 2033, 1.25% 2038 and 3.0% 2054 bonds
Spain	09.30	Auction: To sell 1.3% 2026, 3.55% 2033 and 1.9% 2052 bonds
	09.30	Auction: To sell 11.0% 2030 index-linked bonds
UK	00.01	REC/KPMG report on jobs
	09.30	BoE to publish Decision Maker Panel Survey results
Friday 08 September 2023		
- Nothing scheduled -		

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final manufacturing PMI	Aug	**43.5**	*43.7*	42.7	-
Germany	Final manufacturing PMI	Aug	**39.1**	*39.1*	38.8	-
France	Final manufacturing PMI	Aug	**46.0**	*46.4*	45.1	-
	New car registrations Y/Y%	Aug	**24.3**	-	19.9	-
Italy	Manufacturing PMI	Aug	**45.4**	45.7	44.5	-
	Final GDP Q/Q% (Y/Y%)	Q2	**-0.4 (0.4)**	-0.3 (0.6)	0.6 (2.0)	-
Spain	Manufacturing PMI	Aug	**46.5**	48.8	47.8	-
	New car registrations Y/Y%	Aug	**7.8**	-	10.7	-
UK	Nationwide house price index M/M% (Y/Y%)	Aug	**-0.8 (-5.3)**	-0.4 (-4.9)	-0.2 (-3.8)	-0.3 (-)
	Final manufacturing PMI	Aug	**43.0**	*42.5*	45.3	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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